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No. 354

In the Supreme Court of the United States

OCTOBER TERM, 1944

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ELLIOTT H. WHEELER, ET AL., EXECUTORS OF THE ESTATE OF JOHN H. WHEELER, DECEASED, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The findings and opinion of the Tax Court (R. 57–81) are reported in 1 T. C. 640. The opinion of the Circuit Court of Appeals (R. 121–130) is reported in 143 F. 2d 162.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on May 16, 1944 (R. 130). The petition for certiorari was filed on August 16, 1944, and was granted on October 16, 1944 (R. 131). The jurisdiction of this Court rests upon Section

240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

The taxpayers were stockholders in a corporation which was liquidated in December 1938; the assets were distributed among the stockholders who elected in writing to be taxed under the provisions of Section 112 (b) (7) (E) of the Revenue Act of 1938. The corporation had issued all its capital stock for assorted properties in nontaxable exchanges in 1925 and immediately succeeding years, and prior to the liquidation had sold most of the properties so acquired. The questions are:

1. Whether, under the Revenue Act of 1938 as originally enacted and Article 115-3 of Treasury Regulations 101, the proper basis for determining the "earnings and profits" (sec. 112 (b) (7) (E) of the Revenue Act of 1938) which resulted to the corporation from the sale of the properties for which it had issued its stock is the value of the properties at the time of acquisition by the corporation, or is the cost of the properties to the transferors, the latter being the basis expressly fixed by Article 115-3.

If it should be determined that Article 115-3 of Treasury Regulations 101 is valid and that for that reason the proper basis is the cost of the properties to the transferors, no further questions are presented. If, however, it should be

determined that unless effect be given to the amendment made to Section 115 of the Revenue Act of 1938 by Section 501 of the Second Revenue Act of 1940, the proper basis is the value of the properties at the time of acquisition by the corporation, then the further question is presented:

2. Whether the application here of Section 501 deprives respondents of property without due process of law in contravention of the Fifth Amendment.

STATUTES AND OTHER AUTHORITIES INVOLVED

The statutes and regulations involved are set forth in Appendix A, *infra*, pp. 48–60. Excerpts from the pertinent Congressional Committee Reports are set forth in Appendix B, *infra*, pp. 61–66.

STATEMENT

John H. Wheeler, now deceased and represented by his executors, and the four other respondents owned 90 percent, and Rollo C. Wheeler owned the remaining shares, of the stock of the John H. Wheeler Company, a California corporation, at the time of its liquidation on December 2, 1938.[1] John H. Wheeler and his wife, Frances V.

[1] John H. Wheeler lived until June 14, 1939 (R. 36), but, as his executors represent him, they are referred to herein as "taxpayers". There were five appeals to the Tax Court, one by each of the four individuals and one by the estate. The issue being the same in each case, a consolidated record was prepared and used below. (See R. 113-117.)

Wheeler, had organized the John H. Wheeler Company in 1925, and, during the years following its organization and until the year 1929, the two organizers received the company's 4,918 shares of stock in consideration of certain securities which they transferred to the corporation. The properties so transferred had cost the two organizers $304,683.49, but were worth on the dates of exchange an aggregate fair market value of $491,800, and the corporation set up upon its books the higher figure as the basis of these properties. (R. 31–33, 59–60.)

Prior to liquidation, the corporation had sold most of the securities it had so acquired in exchange for its stock and, in accordance with the applicable Revenue Acts (*viz.*, Section 204 (a) (8) of the Revenue Act of 1924 and corresponding provisions of later Acts), it used the basis of its transferors (John H. Wheeler and wife) in computing its taxable gain or allowable loss upon such sales (R. 33, 60). It invested the net proceeds of its operations in assorted securities (see R. 34).

On December 2, 1938, after giving consideration to the application of Section 112 (b) (7) (E) of the Revenue Act of 1938, the stockholders of the John H. Wheeler Company dissolved the corporation, and all the assets were proportionately distributed in liquidation to the stockholders during December 1938. The assets so distributed consisted of securities having a fair market value

of $624,560[2] and cash in the sum of $111.84. (R. 34, 61–62.) The stockholders of the Wheeler Company, the fair market value of the securities and the cash which each received in the liquidation, and the basis of their Wheeler Company stock were as follows (R. 60, 63):

	Shares held	Fair market value of cash and securities received in liquidation	Basis of Wheeler Company stock
John H. Wheeler	2,459	$312,335.92	$153,505.01
Frances V. Wheeler	491 9/10	62,467.18	30,701.00
Elliott H. Wheeler	491 9/10	62,467.18	30,701.00
Cornelia W. Good	491 9/10	62,467.18	30,701.00
Ysabel F. Berliner	491 9/10	62,467.18	30,701.00
Rollo C. Wheeler	491 9/10	62,467.18	30,701.00
Total	4,918	$624,671.82	$307,010.01

While the foregoing table discloses that each of the stockholders realized through the liquidation of the Wheeler Company a gain in excess of 100 percent on his investment (see Section 115 (c), Revenue Act of 1938), each desired to have his respective gain recognized and taxed under the provisions of Section 112 (b) (7) (E) of the Revenue Act of 1938. Accordingly, each of the stockholders now before this Court executed (and filed with the Treasury Department) a written election on Treasury Form 964 to have his gain in the liquidation so taxed. (R. 35, 63–64.)

[2] Of the properties so distributed, only securities worth $693.87 had been acquired by the John H. Wheeler Company after April 9, 1938. John H. Wheeler's one-half of these securities was worth $346.94. (R. 24, 35, 64.)

As each of the stockholders had received, among other assets in the liquidation, his pro rata share of securities which the Wheeler Company had acquired after April 9, 1938, and of the distributed cash, each of the present taxpayers reported as long term capital gain under Section 112 (b) (7) (E) (ii) his proportionate part of the sum ($805.71) of those two items (see Statement, *supra*, p. 5 and footnote 2). Thus, John H. Wheeler, who owned one-half of the liquidating corporation's stock, reported $402.86 as taxable under Section 112 (b) (7) (E), while each of the other shareholders reported $80.57 as the amount of his taxable gain. (R. 35, 64.) Each stockholder treated the Wheeler Company as a deficit corporation and none of them reported any amount in his respective income tax return as a dividend receipt in connection with the liquidation of the John H. Wheeler Company (*i. e.*, as a distribution out of the corporation's "earnings and profits" (sec. 112 (b) (7) (E) (i)). (R. 35–36.)

The Commissioner of Internal Revenue concluded that the Wheeler Company was not a deficit corporation and determined that the accumulated "earnings and profits" of the Wheeler Company as of December 2, 1938, amounted to $132,813.38 (R. 64). Accordingly, although each shareholder had realized a substantially greater gain in the liquidation, the Commissioner determined that, under Section 112 (b) (7) (E),

each was taxable on only the amount which he had reported for tax purposes plus his share of the distributed "earnings and profits" of the corporation, and that the latter were received as follows (R. 64):

John H. Wheeler	$66,406.60
Elliott H. Wheeler	13,281.38
Frances V. Wheeler	13,281.38
Cornelia W. Good	13,281.38
Ysabel F. Berliner	13,281.38

The Commissioner determined the earnings and profits of the Wheeler Company at the time of its liquidation by using as the basis to the Company for the securities which it had acquired from John H. Wheeler and wife in exchange for its own stock and which it had subsequently sold, the cost of those securities to the Wheelers, the transferors. Since such cost was $180,314.99 [3] less than the book figure at which the company had entered those securities in its books and since the corporation's book deficit, computed by the use of its book figures, was $47,501.61, the undistributed gains, earnings and profits of Wheeler Company at the time of its liquidation were $132,813.48.[4] (R. 33–34, 65.)

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[3] The fair market value of all properties which the Wheeler Company acquired for its stock ($491,800), minus the cost of those properties to the corporation's predecessors in title ($304,684.49), minus $6,800.52 (the excess of book value over transferors' cost of original securities unsold at liquidation of Wheeler Company), constitutes the $180,314.99 (R. 27).

[4] The sum of $180,314.99 minus $47,501.61 equals $132,813.38. A more detailed computation of the Wheeler Company's earnings and profits at liquidation appears in the Record (pp. 17–18). There is, however, an error of $1,000

The Tax Court adjusted the Commissioner's computation of corporate "earnings and profits" at liquidation by an item of $5,953.06 (R. 81)—which was not made an issue in the Circuit Court of Appeals, the Commissioner not having taken a cross-appeal—and otherwise sustained the Commissioner's determination (R. 58–81). The Circuit Court of Appeals reversed the decision of the Tax Court (R. 121–130).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that in computing the accumulated "earnings and profits" (sec. 112 (b) (7) (E) of the Revenue Act of 1938) of the John H. Wheeler Company, a corporation, at the time of its liquidation, the basis for properties acquired in nontaxable exchanges in consideration of its own stock, and subsequently sold, was the fair market value of the properties at the date the corporation acquired them, rather than the cost of the property to the transferors, which became the corporation's basis for determining its tax-

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in that computation, since it is undisputed between the parties that, without regard to the $5,953.06 item mentioned in the last paragraph of this Statement, the Wheeler Company had "earnings and profits" of $132,813.38 on December 2, 1938, if in determining those "earnings and profits" it must use, as the Government contends, the basis of its two predecessors in title for the properties for which the company had issued all its stock.

able gain or allowable loss on the sale or other disposition of the properties.

2. In holding that Section 501 of the Second Revenue Act of 1940, amending Section 115 of the Revenue Act of 1938 (and the corresponding sections of prior Revenue Acts) as of the date of its enactment, is retroactive and not clarifying legislation.

3. In holding that Section 501 is unconstitutional as applied to this case because of objectionable retroactivity.

4. In reversing the decision of the Tax Court.

SUMMARY OF ARGUMENT

For the purpose of computing the earnings and profits of the Wheeler Company at the time of its liquidation, the Commissioner correctly ascribed to the properties which the company had received from Mr. and Mrs. Wheeler in tax-free exchanges for its own stock, the basis which those properties had in the hands of the Wheelers, the transferors.

I

The method which the Commissioner has used here for the determination of "earnings and profits" is correct since it is predicated upon a proper construction of the Revenue Act of 1938 as originally enacted. Not only do the words of the statute support that result, but it is supported by a regulation dealing expressly with the point.

This regulation cannot be said to adopt an unreasonable interpretation of the law and it is therefore valid. Moreover, it represents a long-continued, consistent administrative construction under a series of statutes containing the same language, and ultimately was expressly approved by Congress; it should therefore be deemed to have acquired the force and effect of law.

II

A. The Commissioner's treatment is indisputably correct under Section 501 of the Second Revenue Act of 1940. That Section is by its terms applicable to tax liabilities for the year 1938, and its legislative history unambiguously declares that it was intended to be so appiied.

B. (1) No constitutional objection can be based upon the fact that Section 501 reaches into the past, for it merely resolved a doubt which had arisen in the administration of the preexisting law. From the time of the Revenue Act of 1934, the Treasury Regulations had consistently interpreted the statutes in accordance with the rules subsequently declared by Section 501. Although these Regulations had not been declared invalid either by the Board of Tax Appeals or by any court, two decisions of Circuit Courts of Appeals in 1939, affirming decisions of the Board of Tax Appeals rendered in 1937 and 1938, did cast doubt upon the validity of the administrative interpretation. *Commissioner* v. *F. J. Young Corp.*, 103

F. 2d 137 (C. C. A. 3d); *Commissioner* v. *W. S. Farish & Co.*, 104 F. 2d 833 (C. C. A. 5th). In the year following these decisions, Congress, having made an express finding that the need for certainty made it desirable to clarify the existing law, enacted Section 501 as a ratification and confirmation of the prior administrative construction. Not only is there nothing in the Fifth Amendment which can be said to proscribe such action by the legislative branch of the Government, but it is a practice which should be encouraged. It affords a method of putting to rest troublesome questions arising out of the administration of complex statutory provisions with a speed that can hardly be matched by attempted solution by way of final judicial decisions. It thus avoids long periods of uncertainty and confusion, with resulting benefits to taxpayers and to the courts, as well as to those charged with the duty of administering the law. Moreover, the very nature of the judicial process means that a single decision can settle only a comparatively narrow portion of a problem which may, and usually does, have many ramifications. The legislative process, however, is free from these intrinsic limitations which inhere in the judicial process; the former is a method which is not limited to the confines of a single controversy, either in acquiring the information upon which to act or in providing a solution.

The taxpayers' objection to the application here of Section 501 rests upon the assertions (a) that at the time of the dissolution of the corporation, December 2, 1938, the "law" sanctioned the method which they urge for computing "earnings and profits", and (b) that they relied upon that "law" in liquidating the company.

(a) In December of 1938, the law upon the point was unsettled and there was no basis upon which anyone could justifiably have relied upon the decisions of the Board of Tax Appeals in the *Young* and *Farish* cases. These cases were themselves then under challenge by the Government in the Circuit Courts of Appeals, and in addition there was ample other public notice that it was the Government's position that the Board's view was erroneous.

(b) There is no evidence, and the Tax Court has expressly refused to find, that the taxpayers did in fact rely upon those early Board decisions and would not otherwise have liquidated the corporation.

(2) Even if Section 501 should be treated as effecting a retroactive change in the law, it is nevertheless not unconstitutional. Retroactivity does not spell unconstitutionality and we know of no case holding invalid a provision of any federal income tax on the ground that it violated the Fifth Amendment. The power of Congress to make retroactive changes in the internal

structure of the income tax law is confirmed by a quarter of a century of history of such practice, and aside from the decision here under review, by the decision in every case in which an objection upon the score of retroactivity has been raised.

ARGUMENT

Introductory.—On December 2, 1938, the Wheeler Company was liquidated pursuant to Section 112 (b) (7) of the Revenue Act of 1938 (Appendix A, *infra*, pp. 49–51) which provided an elective method for taxing stockholders upon the liquidation of a corporation. Under this method each shareholder was to be taxed only upon that portion of the gain realized in the liquidation which represented the shareholder's ratable share of the corporation's accumulated "earnings and profit" (sec. 112 (b) (7) (E)). Recognition and taxation of the balance of the gain [5] realized upon the liquidation was to be postponed until the property received was disposed of by the shareholders. See Section 113 (a) (18) (Appendix A, *infra*, p. 52).

The issue herein arises with respect to the correct basis to be used for determining "earnings

[5] Except for that portion representing cash, or securities acquired by the liquidating corporation after April 9, 1938, and this portion was to be taxed as capital gain. Section 112 (b) (7) (E) (ii). In the present case the corporation distributed cash and such securities in a total of $805.71 (R. 35, 64). There is no dispute between the parties with respect to the taxation of this item.

and profits" realized by the Wheeler Company upon its disposition (prior to the liquidation) of the securities which it had acquired in tax-free exchanges for its own stock. The taxpayers contend that for the purpose of computing the amount of "earnings and profits" realized by the corporation upon the disposition of these assets, the basis should be their value when acquired by the corporation, $491,800. The Commissioner, on the other hand, contends, as he appears consistently to have contended in all similar cases, that the same basis must be used for the determination of earnings and profits as is used for the determination of taxable gain or allowable loss to the corporation, *i. e.*, $304,683.49, the cost of these securities to the corporation's transferors, Mr. and Mrs. John H. Wheeler.

Section 501 (a) of the Second Revenue Act of 1940 (Appendix A, *infra*, pp. 54–56) makes it clear that the Commissioner's position is correct, for it provides expressly that "earnings and profits" shall be determined by taking the same basis as that which is applicable for determining gain or loss in computing net income. And subsection (*e*) of Section 501 directs that the provisions of subsection (a) shall "for the purposes of the Revenue Act of 1938 or any prior Revenue Act * * * be effective as if they were a part of each such Revenue Act on the date of its enactment." The court below has held, however, that application of these provisions of the Second Revenue Act of

1949 offends the due process clause of the Fifth Amendment and in so holding seems to have assumed that the effect of Section 501 was to make a radical alteration in the prior law and that it was therefore strictly retroactive legislation.

If, as we contend, the basis used by the Commissioner is correct under the law as it stood prior to the enactment of Section 501, it will be unnecessary to consider the constitutional question. If, however, the Court should reach the question of the constitutional validity of the application of Section 501, then we respectfully submit that in no view of the case should it be held that, as here applied, the Section is unconstitutional. It does not constitute retroactive legislation in any true sense, for its purpose and effect was merely to clarify a doubtful point which had arisen under the existing law. And even if the amendment be treated as effecting a sharp change in the prior law and therefore truly retroactive, it is nevertheless not unconstitutional.

I

REGARDLESS OF SECTION 501, THE BASIS USED BY THE COMMISSIONER FOR THE DETERMINATION OF "EARNINGS AND PROFITS" IS CORRECT

We submit that even if Section 501 be not applied, the Commissioner's method for the determination of "earnings and profits" is nevertheless correct, for it is predicated upon a correct

construction of the Revenue Act of 1938 as originally enacted.

Since the adoption of the Sixteenth Amendment, all of the Revenue Acts have included "dividends" in the gross income of individuals which, less deductions, is subject to tax. All Revenue Acts from that of 1916 (Section 2 (a) thereof) to and including Section 115 (a) of the Internal Revenue Code, have defined the term "dividends" as any distribution made by a corporation, whether in cash or other property, out of its "earnings or profits". In time Congress provided that no gain or loss should be recognized upon the transfer of property to a corporation by persons in exchange for the corporation's stock where immediately after the exchange the transferors were in control of the corporation, and then to prevent evasions provided that the basis to the corportion for property so acquired should be the same as it would be in the hands of the transferor.

Eventually some taxpayers raised the question whether a corporation's basis for determining its "earnings or profits" upon the sale or other disposition of property for which it had issued its

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See, *e. g.*, Section 202 (c) (3), Revenue Act of 1921; Section 203 (b) (4), Revenue Act of 1924; Section 112 (b) (5), Internal Revenue Code.

See, *e. g.*, Section 204 (a) (8), Revenue Acts of 1924 and 1926; Section 113 (a) (8), Internal Revenue Code; Paul, Studies in Federal Taxation (Third Series) 3, 30.

stock, was the same as the corporation's basis for determining its gain or loss from the particular sale or disposition of the property. To resolve any possible obscurity on this point, the Treasury Department covered it by regulation. Article 115-1, Treasury Regulations 86, relating to the Revenue Act of 1934, provided:

> Gains and losses within the purview of section 112, are brought into the earnings and profits account at the time and to the extent such gains and losses are recognized [for tax purposes] under that section.

The same provision was repeated in subsequent Regulations which implemented like provisions of the subsequent Revenue Acts.[8] In essence, the rule stated in the Regulations rested upon the view that the provisions of the Acts directing the nonrecognition of gain or loss upon reorganization exchanges were to be read together with the provisions of Section 115 which defined dividends, and this construction is supported by both the language and purpose of the statutory provisions so implemented. Although prior to the enactment of Section 501 there was no statutory provision dealing expressly with the precise point covered by the regulation, the Revenue Acts did contain

[8] See Article 115-3 of Treasury Regulations 94 (1936 Act) and Treasury Regulations 101 (1938 Act); Section 19.115-3 of Treasury Regulations 103 and Section 29.115-3 of Treasury Regulations 111, promulgated under the Internal Revenue Code.

rather clear indication that gains and losses not recognized for the purpose of computing taxable income should likewise not be recognized for the purpose of computing "earnings and profits", and that, as one consequence thereof, upon the disposition of property acquired in a tax-free exchange "earnings and profits" should be determined by taking the same basis as would be applicable for the determination of taxable gain or loss. Section 111 (c) of the Revenue Act of 1938 (Appendix A, *infra*, p. 48) provided:[9]

> (c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized *for the purposes of this title*, shall be determined under the provisions of section 112. [Italics supplied.]

Since Section 115, which defines dividends, is part of the same title as Section 111, the words "for the purposes of this title", as has been observed,[10]

> seem to lead inescapably to the conclusion that unrecognized gains are to remain un-

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[9] The language is similar in all of the Acts since that of 1924 in which the basic pattern of the reorganization provisions and their correlative basis provisions was set. See Section 202 (d) of the Revenue Acts of 1924 and 1926; Section 111 (d) of the Revenue Act of 1928; Section 111 (c) of the Revenue Acts of 1932, 1934, 1936, 1938 and of the Internal Revenue Code.

[10] Paul, Selected Studies in Federal Taxation (Second Series) 149, 194.

> recognized *for all income tax purposes,* and that the nonrecognition provisions apply as well to the ascertainment of "earnings or profits" as to the computation of taxable net income. [Italics in text.]

It should be observed that the construction placed upon the Acts by the regulation is not a one-way rule operating always in favor of the revenue; in many cases it results in a smaller tax. Thus under the regulation and Section 501, earnings and profits available for dividends are often minimized.[11]

This construction, moreover, is in accord with the fundamental principle of the nonrecognition provisions that the exchanges therein described should be without tax effect because economically they do not result in changes in substantive interests, but are alterations in form only. It would be inconsistent with this principle to ascribe tax results indirectly to such exchanges by reflecting their effect in the determination of "earnings and profits." This is the underlying theory in the leading case of *Commissioner* v. *Sansome*, 60 F. 2d 931 (C. C. A. 2d), certiorari denied, 287 U. S. 667, in which the court stated that the nonrecognition provisions (p. 933) "should be read as a gloss" on the provisions defining dividends, and which

[11] See the illustrations in the Committee Reports, and Paul, Studies in Federal Taxation (Second Series) 149, 185–199; see also pp. 41–42 *infra*.

has been approved by the Congress on several occasions.[12]

The issue does not turn, however, upon a showing that the statutory provisions inevitably required the construction placed upon them by Article 115-4 of Treasury Regulations 86, and the similar provision in the succeeding Regulations.[13] The regulation should not be held invalid "unless unreasonable or inconsistent with the statute". *Fawcus Machine Co.* v. *United States*, 282 U. S. 375, 378. It is enough that the statutes did not require a contrary construction, for the regulation represents, at the minimum, a permissible construction upon a doubtful point by the officials charged with the duty of administering the law. This should be sufficient to sustain its validity. *Boske* v. *Comingore*, 177 U. S. 459, 470; *Brewster* v. *Gage*, 280 U. S. 327, 336; *United States* v. *Kirby Lumber Co.*, 284 U. S. 1, 3; *Securities Allied Corp.* v. *Commissioner*, 95 F. 2d 384 (C. C. A. 2d), certiorari denied, 305 U. S. 617.

Moreover, following the promulgation under the Revenue Act of 1934 of the first regulation upon the point, Congress reenacted the statutory provisions without change in the Revenue Acts of 1936 and 1938, and, until the enactment of Sec-

[12] In addition to the approving reference to the *Sansome* case in the House Committee Report relating to Section 501 (Appendix B, *infra*, p. 61), see S. Rep. No. 2156, 74th Cong., 2d Sess., p. 19 (1939-1 Cum. Bull. (Part 2) 678, 690).

[13] See p. 17, *supra*.

tion 501 of the Second Revenue Act of 1940, made no change in this respect in the Internal Revenue Code in any of the Revenue Acts passed after the adoption of the Code in 1939. In this connection it should be noted that in the Revenue Act of 1936, Congress legislated with respect to one aspect of the "earnings and profits" problem by providing expressly (Section 115 (h)) that "earnings and profits" should not be deemed to be diminished by corporate distributions which were not subject to tax in the hands of the shareholders. In view of the importance of accurate rules for computing "earnings and profits" under the Revenue Act of 1936, because of the surtax on undistributed profits which was levied by that Act, the failure of Congress to disapprove the rule stated in Article 115-1 of Treasury Regulations 86 is especially significant. Under the familiar doctrine, the regulation should be deemed to have acquired the force and effect of law. *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459; *Helvering* v. *Winmill*, 305 U. S. 79, 83; *Helvering* v. *Griffiths*, 318 U. S. 371, 395, 397.

In addition to the significance attributable to the failure of Congress to disapprove the administrative construction when it enacted the Revenue Act of 1936 and subsequent Revenue Acts, the rule that the regulation should be given the force and effect of law has special applicability here, for it does not depend upon an implication that Congress approved the administrative construc-

tion by failing to disapprove; here the approval was pointedly and expressly voiced by the enactment of Section 501 of the Second Revenue Act of 1940 by which Congress wrote into all of the Revenue Acts the rule stated in the Regulations. Cf. *Morrissey* v. *Commissioner*, 296 U. S. 344; *Old Mission Co.* v. *Helvering*, 293 U. S. 289.

Although the Board of Tax Appeals took a view of the statute contrary to that expressed in the Regulations, and the Board's view has been sustained by the Third and Fifth Circuits, neither it nor those courts (nor the Ninth Circuit in the instant case) has ever considered whether the regulation represents a permissible construction of the statute.

In *F. J. Young Corp.* v. *Commissioner*, 35 B. T. A. 860, affirmed, 103 F. 2d 137 (C. C. A. 3d), the Board held that an unrecognized gain resulting to a corporation from a tax-free exchange by it of certain assets for stock of the transferee corporation effected an increase in the transferor's earnings and profits available for dividend distribution. In *W. S. Farish & Co.* v. *Commissioner*, 38 B. T. A. 150, affirmed, 104 F. 2d 833 (C. C. A. 5th), it was held that in determining whether a corporation had been availed of for the purpose of preventing the imposition of surtax upon its shareholders through the unreasonable accumulation of "gains and profits", the corporation could compute its gains and profits on the basis of the market value of assets

which it had acquired in a tax-free exchange rather than upon the transferor's basis.

Although Treasury Regulations 86 had been promulgated prior to the decisions in these cases, both of them involved tax years prior to those covered by those Regulations, and Article 113-1 thereof was disposed of in the *Young* case, both by the Board and the Third Circuit Court of Appeals, upon the ground that it was for that reason inapplicable. In the *Farish* case neither the Board nor the Fifth Circuit referred to the regulation. Thereafter, in subsequent cases, the Board has relied upon the authority of its own decisions and has adhered to its view.[14]

[14] *Elmhirst* v. *Commissioner*, 41 B. T. A. 348; *Faulkland Corp.* v. *Commissioner*, decided November 8, 1941 (1941 P-H B. T. A. Memorandum Decisions Service, par. 41,497); *Estate of Fisher* v. *Commissioner*, decided April 26, 1944 (1944 P-H Memorandum Decisions Service, par. 44,132); *Senior Investment Corp.* v. *Commissioner*, 2 T. C. 124. The *Fisher* and *Senior Investment* cases are now pending on the Commissioner's appeal in the Circuit Court of Appeals for the Sixth Circuit. In the *Elmhirst* case the Commissioner published his nonacquiescence (1941-1 Cum. Bull. 10) and took an appeal but while the case was pending an offer in compromise was accepted and the appeal was dismissed. The *Faulkland* case was likewise appealed by the Government, but while pending the case was rendered moot by the enactment of Section 501 of the Revenue Act of 1942 which by adding Section 26 (f) to the Revenue Act of 1936 entitled the taxpayer to a credit sufficient to expunge the deficiency regardless of the correctness of the grounds upon which the Board had predicated its decision. In consequence, the Board's decision was affirmed upon stipulation of the parties.

The Board's view appears to be based upon the thought that the nonrecognition provisions apply only to the determination of gains or losses for the purpose of computing tax, but not for the purpose of determining the earnings and profits of a corporation available for distribution as a dividend. We think this involves a disregard of Section 111 which directs, as we have pointed out, that the nonrecognition provisions should be applied for all purposes of the income tax title. In any event the question is not whether the regulation adopted the best of all possible constructions of the statute but simply whether it adopted a reasonably permissible construction, and we submit that in no view of the statute can it be said that the regulation is plainly erroneous. In this connection it should be pointed out that the regulation antedated any of the Board's decisions upon the question. Treasury Regulations 86 were approved by the Secretary of the Treasury on September 6, 1934, and the *Young* and *Farish* cases were not decided by the Board of Tax Appeals until 1937 and 1938, respectively.[8] Even if the Board of Tax

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[8] The taxpayers have contended that in several cases prior to the *Young* and *Farish* decisions the Board of Tax Appeals had announced similar principles. See the cases collected in note 3 of the opinion below (R. 126). We do not agree that these cases may be so read but, in any event, all of them, except for *Ayer v. Commissioner*, 12 B. T. A. 284, were decided after the promulgation of Treasury Regulations 86. The *Ayer* case was decided in 1928 in favor of the Government and held, following a regulation dealing with the precise

Appeals had announced its view prior to the promulgation of the regulation, that would not have precluded the Treasury, in the exercise of its continuing rule-making power, from promulgating a different interpretation which, if reasonable, would be binding. *Helvering* v. *Reynolds*, 313 U. S. 428, 430–433.

II

THE BASIS USED BY THE COMMISSIONER FOR THE DETERMINATION OF "EARNINGS AND PROFITS" IS CORRECT UNDER SECTION 501

A. THE SECTION IS APPLICABLE

The taxpayers may renew here the contention which they have urged below that the effective date of Section 501 is ambiguous and that it should therefore be construed to apply only to 1939 and subsequent taxable years. However, as both of the courts below have held, the Section was clearly intended to be fully and completely applicable to the year 1938 as well as to prior years; the terms of the Section and its legislative history permit of no other conclusion.

Subsection (a) amends the Internal Revenue Code and declares the rules for the determination of earnings and profits; subsection (b) provides for the application of subsection (a) to all

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point, that a distribution out of a depletion reserve based on discovery value was a dividend to the extent that the reserve represented the excess of the discovery value over cost.

taxable years beginning after December 31, 1938; and subsection (c) provides that—

> For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the date of its enactment.

The words of the Section are plain and no ambiguity can be distilled from its form. The form in which the Section is cast is one which has frequently been used since the codification of the revenue laws in 1939 into the Internal Revenue Code. With respect to the income tax, all taxable years beginning after December 31, 1938, are governed by the Code[16] and subsequent Revenue Acts have been in the form of amendments to the Code. In general, the amendments made by the later Acts have been made applicable only for the year in which the particular Act was adopted, and for future years.[17] Where it has been intended that a particular provision be applicable for the years between the adoption of the Code and the enactment of the amendment, that has been accomplished by a provision similar to

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[16] Section 1.

[17] *E. g.*, Section 5 of the Revenue Act of 1940, Section 101 (c) of the Second Revenue Act of 1940, Section 118 of the Revenue Act of 1941, and Section 101 of the Revenue Acts of 1942 and 1943.

subsection (b) of Section 501,[18] and where it has been intended that a provision be applicable to years prior to those governed by the Code, that has been accomplished by a provision similar to subsection (c) of Section 501,[19] quoted above.

Moreover, the final sentence of subsection (c),[20] which provided that the amendment should not affect tax liabilities in cases pending in the Board of Tax Appeals or in a court on September 20, 1940, would be completely without meaning if it

[18] See, *e. g.*, in the 1942 Act, Sections 116 (b), 121 (d), 134 (f), 146 (b) and 186 (f).

[19] See, *e. g.*, in the 1942 Act, Sections 116 (c), 121 (e), 134 (g), 146 (b), 161 (b), 186 (f) and 501 (b).

[20] This sentence reads:

> Nothing in this subsection shall affect the tax liability of any taxpayer for any year which, on September 20, 1940, was pending before, or was heretofore determined by, the Board of Tax Appeals, or any court of the United States.

This exception was introduced in the Senate by the Finance Committee, whose report, as well as that of the Conference Committee (Appendix B, infra, pp. 63, 65–66), makes clear that Congress did not intend to direct that rules different from those provided by subsection (a) be applied to cases pending on September 20, 1940. The exception means only that the rules of subsection (a) are not *required* to be applied to pending litigation, and appears to represent no more than a scrupulous avoidance of direct interference by the Congress in the decision of cases then before the courts. Consistently with the view that Section 501 merely represents the proper interpretation of the prior law, T. D. 5024, 1940–2 Cum. Bull. 110, 117, provides that the same rules are applicable to cases pending on September 20, 1940, as are applicable to other cases.

had not been intended by the subsection to affect all tax liabilities for the year 1938 other than in cases pending on that date. It will be observed that the exception appears in, and is limited to, subsection (e) which deals only with the year 1938 and prior years.

Any possible remaining doubt is dispelled by the Committee Reports. The House Report states (Appendix B, *infra*, p. 61): "Section 401 of the bill inserts subsection (1) in section 115 of the Internal Revenue Code and correspondingly amends prior Revenue Acts". The Senate Report deals at length with the point and both it and the Conference Report explain the application of the exception made by the last sentence of Section 501 (e) in terms which permit of no meaning other than that, save for cases covered by the exception, the Section provided (p. 63, *infra*) "a uniform rule * * * for all prior taxable years".

It is, of course, true that, in general, an ambiguous statute will be construed to have prospective operation only and that a construction which avoids consideration of a constitutional question will be preferred over one which raises substantial constitutional issues; but these general rules for ascertaining the Congressional intent have no place where, as here, that intent is plain. See *Hopkins Savings Assn.* v. *Cleary*, 296 U. S. 315, 334-335.

Courts have striven mightily at times to canalize construction along the path of

> safety. *Moore Ice Cream Co. v. Rose*, 289 U. S. 373, 379. When a statute is reasonably susceptible of two interpretations, they have preferred the meaning that preserves to the meaning that destroys. *United States v. Delaware & Hudson Co.*, 213 U. S. 366, 407; *Knights Templars' Indemnity Co. v. Jarman*, 187 U. S. 197, 205; cf. *Illinois Central R. Co. v. Public Utilities Comm'n*, 245 U. S. 493, 510; *Savage v. Jones*, 225 U. S. 501, 533. "But avoidance of a difficulty will not be pressed to the point of disingenuous evasion." *Moore Ice Cream Co. v. Rose, supra.* "Here the intention of the Congress is revealed too distinctly to permit us to ignore it because of mere misgivings as to power." *Ibid.* The problem must be faced and answered.

See also *Cooper v. United States*, 280 U. S. 409.

B. THE SECTION IS CONSTITUTIONAL

1. The Section merely resolved a doubt which had arisen under the existing law and Congress has power so to act

(a) The *Young* and *Farish* cases (*supra*, p. 22), which had been decided by the Board of Tax Appeals in 1937 and 1938, respectively, were affirmed by the Third and Fifth Circuits in 1939. Although these cases involved taxable years prior to those covered by the regulation and therefore did not directly rule upon its validity, they obviously did cast an aura of doubt about the correctness of the administrative interpretation of the statute upon an important and often recurring question. It

was in these circumstances that, in the year following the Circuit Court of Appeals decisions in those cases, Congress, finding that the "need for certainty" made "it desirable to clarify existing law,"[22] enacted Section 501 of the Second Revenue Act of 1940, ratifying the rule expressed in the Treasury Regulations. As we have pointed out under point I herein (p. 19, *supra*), the rule thus ratified is not a one-way rule, for its operation may in many cases result in a smaller tax.

The Committee Reports leave no room for doubt that Congress was of the view that, by enacting Section 501, it was doing no more than providing expressly for a rule which had always been intended. Such a declaration of Congressional purpose should be conclusive. *Helvering v. Twin Bell Syndicate*, 293 U. S. 318, 322; cf. *Helvering v. N. Y. Trust Co.*, 292 U. S. 455, 468-469; *Harrison v. Northern Trust Co.*, 317 U. S. 476, 479.

The report of the Committee on Ways and Means states at the outset that the purpose of the provision "is to clarify the law". It then refers with approval to the decision in the *Sansome* case (see p. 19, *supra*) and to the rule "applied by the Treasury under existing law", with the comment that that rule "effectuates the provisions of section 112". After pointing out that—

> While taxpayers generally have concurred in the rule applied by the Treasury, the

[22] See H. Rep. No. 2894, Appendix B, *infra*, p. 62.

> Board of Tax Appeals and some of the courts have not agreed but have followed the theory that gain or loss, even though not recognized in computing net income, nevertheless affects earnings and profits. * * *

and referring specifically to the *Young* case as an example, the Committee stated that "the need for certainty, * * * makes it desirable to clarify existing law". The first sentence of that portion of the Finance Committee's report dealing with Section 501 states that "The committee amendment rearranges section 401 of the House bill but otherwise makes no substantial change".

The court below remarked with respect to these clear statements of the Congressional understanding of the legislation as merely clarifying that (R. 127) "this was eliminated before its passage". This comment seems to have resulted from confusion on the part of the court between the drafts of the legislation and the Committee Reports. None of the drafts of what became Section 501 ever contained any statement that its purpose was to clarify the law, and of course one would not expect to find such a statement in the Section itself. The declarations that the purpose of the amendment was to clarify the existing law appeared where they would be expected to be found, in the Committee Reports. And nothing has been found in the course of the whole legislative history of this provision to indicate that anyone in the Congress thought, at

any stage, that the intent and understanding were other than that expressed in the Committee Reports.

There is thus presented a situation in which the year following two judicial decisions which cast doubt upon the validity of a consistent administrative construction upon a narrow but important point of tax administration, Congress approved and confirmed the administrative understanding of the law, thus effecting a clear, precise, and speedy solution of a troublesome question. We submit that legislative action in such circumstances is not only not unconstitutional, but is salutary. We do not believe that there can be read into the Fifth Amendment any prohibition against such a practice; it is one which should be encouraged, not discouraged, for it affords a method of materially lessening the interim of uncertainty and confusion which attends the necessity of awaiting a final and authoritative judicial decision, with resulting benefits to the administrators of the law, to those subject to the law, and to the courts.

Speedy solution is not the only advantage lying with this legislative method. The clarification of complex provisions of the tax statutes by means of judicial decisions is an "inevitably empiric process". Rarely can a single decision settle more than a comparatively narrow portion of a

Helvering v. Hallock, 309 U. S. 106, 119.

problem which may, and usually does, have many ramifications. Congress, however, may paint with a broader brush. The legislative process is not limited to the confines of a single controversy, either in acquiring the information upon which to reach a decision or in providing a solution.

Finally, the practical effect of a denial of Congressional power here would be to require every disputed question of the interpretation of the revenue laws to be brought to this Court for settlement, for it would rule out the only alternative, that of going to Congress for a clarifying amendment applicable to prior years.

(b) It is urged by the taxpayers, and the court below has held, that Congress was without power so to act. The essence of the taxpayers' position is that, even if (as the enactment and legislative history of Section 501 show) the Board's decisions in the *Young* and *Farish* cases were erroneous, they somehow acquired a vested right in those decisions, a right so complete as to be entitled to constitutional protection. Cf. *Dunbar* v. *City of New York*, 251 U. S. 516, 518–519; *United States* v. *Heinszen & Co.*, 206 U. S. 370, 386–388. The contention takes the form of an assertion that at the time of the dissolution of the Wheeler Company on December 2, 1938, the "law" sanctioned the method which the taxpayers urge for computing "earnings and profits," and the inference is sought to be created that they relied upon that "law" in liquidating the company. From these

premises the conclusion is urged that application here of a different rule is "unfair" and that such "unfairness" is unconstitutional.

We submit, however, that neither premise of the argument is well founded. There is no basis for the taxpayers' view as to what the "law" was on December 2, 1938, and there is likewise no basis for their assertion that they did in fact rely upon that "law". Furthermore, even if it should be assumed that both of these premises are valid, there is nevertheless no constitutional objection to the application here of Section 501.

1. The Board of Tax Appeals decided the *Young* case in 1937 and the *Farish* case in 1938. The Commissioner announced his nonacquiescence[3] in the *Young* case, and took an appeal in it and in the *Farish* case, and the affirmances of these decisions by the Third and Fifth Circuits did not come until 1939. Thus the "law" on December 2, 1938, consisted of the Revenue Act of 1938 (which contained no provision expressly dealing with the precise question of the proper method of computing earnings and profits upon the disposition by a corporation of properties acquired in a tax-free exchange), the Treasury Regulations, (which expressly announced a rule contrary to the taxpayers' view and which neither the Board of Tax Appeals nor any court had held invalid)[4]

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[3] 1937-2 Cum. Bull. 56.

[4] At the time of the dissolution of the Wheeler Company neither the Board of Tax Appeals nor any court had held

and the decisions of the Board of Tax Appeals in the *Young* and *Farish* cases (decisions with respect to which the Commissioner had announced his disagreement and which he was then challenging in the Circuit Courts of Appeals). The taxpayers have argued, and the Circuit Court of Appeals seems to have thought (see footnote 3 of the opinion, R. 126), that several decisions of the Board of Tax Appeals prior to the *Young* case had also announced the rule for which they contend. We do not agree that these decisions stand for the proposition for which they have been urged (see note 15, p. 24, *supra*), but it does not appear necessary to discuss them at length. Not only did none of them deal with or involve the regulation, but for present purposes the decisive consideration is that at the time of the dissolution of the Wheeler Company there was not only no final decision upon the point, but there was ample notice that the Government was of the view that the Board's position was erroneous. This notice was given by the announced nonacquiescence in the *Young* case, by the prosecution of appeals from the adverse

the regulation invalid. Nor even since that time has any appellate court, except for the decision in the instant case, held the regulation invalid. That issue is now pending in the Sixth Circuit in *Estate of Fisher v. Commissioner*, decided by the Tax Court on February 9, 1944 (1944 P-H T. C. Memorandum Decisions Service, par. 44,034), a case arising under the last sentence of Section 501 (c) which excepted from operation of the Section cases in litigation on September 20, 1940. See p. 27, *supra*.

Board decisions, and by the adherence to and repromulgation of the regulation.[25]

Although the attention of the Circuit Court of Appeals was directed to these facts which show the unsettled state of the law at the time of the dissolution of the Wheeler Company, the court responded by characterizing the point as a "boast" that the Commissioner "had flouted the court [Board of Tax Appeals]" (R. 126). The Commissioner's practice of announcing acquiescence or nonacquiescence in Board decisions is not, however, thus to be condemned, for it is a desirable practice dating from the inception of the Board of Tax Appeals. It indicates the course of "official opinion in the administration of the Bureau of Internal Revenue"[26] which furnishes a guide not only for the personnel of the Bureau, but to taxpayers and their counsel. There is no express provision in the statutes requiring the Commissioner to announce such acquiescence or nonacquiescence, but the practice has been deemed so desirable that when, in 1926, the Board was established in its present form, representatives of taxpayers urged Congress to make it mandatory. Such a require-

[25] Thus Treasury Regulations 101 were promulgated on July 19, 1938 (p. 741) while the *Young* case was pending on appeal, and Treasury Regulations 103 were promulgated on August 25, 1939, after the Circuit Courts of Appeals had decided both the *Young* and *Farish* cases.

[26] See the notice appearing on the front cover sheet of each issue of the Internal Revenue Bulletin. Cf. *Helvering* v. *N. Y. Trust Co.*, 292 U. S. 455, 468.

ment was not incorporated into the law only, it seems, because it was unnecessary, since the Commissioner was already following the practice.[27]

These are considerations of weighty significance in considering the charge of unconstitutionality, which is here leveled at Section 501. No one could have justifiably assumed on December 2, 1938, that the Board's view as expressed in the *Young* and *Farish* cases was correct. Cf. *Higgins* v. *Smith*, 308 U. S. 473, 478–479. Those cases were themselves then pending on appeal and there was certainly a possibility that they would be reversed by the Circuit Courts of Appeals in which they were pending. Even if, as later developed, those courts did affirm the decisions, there was the additional possibility that the Government's view would ultimately be sustained by this Court, either in the *Young* and *Farish* cases or in some other case, such as this one. Thus, even if it should be assumed that the taxpayers knew, or were advised, of the state of the law upon this point concerning reorganizations under the tax statutes, and if in that situation they determined to liquidate the Wheeler Company in reliance upon the Board's decisions, they did no more than elect to challenge the Government on its position, knowing that there was at least the possibility that the Government would ultimately be sustained.

[27] See Revenue Revision 1925, Hearings before the Committee on Ways and Means, 69th Cong., 1st Sess.; pp. 849, 878, 926–7, 931, 933, 937.

2. Not only was there no basis upon which any-one could justifiably have relied on December 2, 1938, upon the Board's decisions as establishing the "law" with respect to the method of computing "earnings and profits" upon the disposition by a corporation of assets acquired in a tax-free exchange, but there is no evidence in the Record, and the Tax Court expressly refused to find, that the taxpayers herein did in fact so rely.

It is stipulated that the dissolution occurred after consideration was given (R. 34) "to the application of Section 112 (b) (7) of the Revenue Act of 1938". That Section provided that upon the liquidation of a corporation pursuant to its provisions, the shareholders should be taxed on that portion of their resulting gain which represented the corporation's "earnings and profits", but it said nothing about how "earnings and profits" should be computed. The stipulation does not state, nor is there anything in the Record to show, that the taxpayers took into account or relied upon the Board's then view as to how "earnings and profits" should be computed in a situation such as is here involved. We do not believe that the Record would support a finding in accordance with the taxpayers' assertion as to their reliance, but it may be assumed *arguendo* that the Tax Court might properly have drawn the inference, and therefore might properly have made a finding, that the taxpayers did in fact rely upon those early decisions and would not otherwise have

liquidated the corporation. However, the Tax Court did not draw that inference and did not make such a finding; instead, it expressly refused to do so.

The Tax Court pointed out that Congress, having found that the use of personal holding companies was "the most prevalent form of tax avoidance practiced by individuals with large incomes",[28] had from the Revenue Act of 1934 to that of 1938 imposed progressively heavier taxes upon such corporations, until by 1938 there was, in many instances, no longer any tax benefit in the use of personal holding companies but they had come in fact to be tax burdens; that therefore quite aside from the opportunity afforded by Section 112 (b) (7) there was strong motivation in 1938 to be rid of personal holding companies (R. 73–74); and that even with the tax computed under the Commissioner's method of determining "earnings and profits" the taxpayers paid a substantially lower tax as the result of the application of Section 112 (b) (7) than they would have paid had the Wheeler Company been liquidated without electing to come under that Section (R. 78–79). The Tax Court consequently characterized as (R. 74) "without substance" the taxpayers' contention that they would not have liquidated the corporation had they not expected the tax to be

[28] H. Rep. No. 704, 73rd Cong., 2d Sess., p. 11 (1939-1 Cum. Bull. (Part 2) 554, 562).

computed in accordance with their method of determining "earnings and profits".

These portions of the Tax Court's opinion deserve attention in view of the language in which its opinion was criticized by the Circuit Court of Appeals. The Tax Court did not make any affirmative finding that the Wheeler Company was formed for purposes of tax avoidance, or that its dissolution was motivated by such considerations, nor did it make any affirmative finding that the Wheeler Company would have been liquidated in 1938 even if the benefits of Section 112 (b) (7) had not been available. The Tax Court simply stated its reasons (a) for concluding that application of Section 501 did not lead to any harsh result, and (b) for declining to draw the inference or to make the finding pressed by the taxpayers that they did in fact reply upon the early Board decisions and would not otherwise have liquidated the corporation. The Tax Court's discussion was germane to the issues argued by the taxpayers. The Circuit Court of Appeals, however, charged the Tax Court with making findings which were unsupported by the Record; characterized its discussion as (R. 125) "betray[ing], an animus against" the taxpayers "because they were stockholders" in "a personal holding company"; and censured the Tax Court with the statements that it was "prejudice[d]" and had not adopted an "impartial approach to the issues". As we have

undertaken to show, analysis of the Tax Court's opinion reveals that these serious charges are without foundation.

The views of the Circuit Court of Appeals seem to have followed, at least in part, from a misunderstanding of the effect of Section 112 (b) (7), and of the application to that Section of the rule stated in the regulation, which Section 501 confirmed, for the determination of earnings and profits. The court pointed out (R. 125) that Section 112 (b) (7) "was enacted for the purpose of encouraging and facilitating prompt liquidation of personal holding companies," and added that under the Commissioner's method of computing earnings and profits there would not have been "such or any encouragement". But we feel that the court was in error in its conclusion, both with respect to the general effect upon Section 112 (b) (7) of the Commissioner's method of computing earnings and profits and with respect to its application in this case. As we have pointed out (*supra*, pp. 19, 30), the rule confirmed by Section 501 does not always result in a larger tax. With respect to companies which, like the Wheeler Company, had acquired assets in tax-free exchanges for their own stock and were contemplating liquidation pursuant to Section 112 (b) (7), the tax would be less under the rule applied by the Commissioner than under the rule which the taxpayers here urge, if the assets acquired

had been worth less at the time of acquisition than their cost to the transferors, and had thereafter appreciated in value by the time of their subsequent sale by the corporation. And, as the Tax Court pointed out (R. 78-80), with respect to its effect in the instant case, even under the Commissioner's application of Section 112 (b) (7)[3] there was ample encouragement for the liquidation of the Wheeler Company, since the tax was much less than would have been due if the liquidation had been effected without the benefits of that section.

2. Even if the Section be treated as effecting a clear and sharp change in the prior law, it is nevertheless not unconstitutional.

Assuming, *arguendo*, that the taxpayers' contentions with respect to the state of the law on December 2, 1938, and their alleged reliance

[3] In the case of John H. Wheeler, for example, the liquidation resulted in a gain under Section 115 (c) of the 1938 Act, of at least $158,830.91, since the basis for his stock did not exceed $153,505.01, and he received in exchange therefor property worth $312,335.92 (R. 63; cf. R. 78). Under Section 117 (b) $79,415.46 (50 percent of the gain) would have been taxable in 1938. Under the Commissioner's application of Section 112 (b) (7) the total gain subject to tax was only $66,809.55 (consisting of a dividend out of "earnings and profits" in the amount of $66,406.69, and 50 percent ($402.86) of the total of cash and post September 9, 1938 securities received in the liquidation). (See Statement, *supra*, p. 6.) In addition, the amount taxable as a dividend was reduced by $2,976.53 as a result of the Tax Court's modification of the Commissioner's computation of "earnings and profits" by the item of $5,953.06 (see Statement, *supra*, p. 8).

thereon, are valid, there would nevertheless be no constitutional objection to the application of Section 501. Retroactivity does not spell unconstitutionality. Retroactivity in varying degrees has been a feature of every federal income tax since those first enacted during the Civil War days, but they have been uniformly held unobjectionable on that account whenever the point has been raised.[30] Indeed, the decision of the Circuit Court of Appeals herein appears to be the first by any court which has held a federal income tax provision violative of the due process clause. Cf. *Hudson* v. *United States*, 12 F. Supp. 620, 13 F. Supp. 640 (C. Cls.), reversed, 299 U. S. 498.

Cyrliss v. *Bowers*, 281 U. S. 376; *Reinecke* v. *Smith*, 289 U. S. 172, and *Burnet* v. *Wells*, 289 U. S. 670, involved provisions taxing the income of certain trusts to the settlor and sustained their application to trusts created when there was no such provision in the law. *Cooper* v. *United States*, 280 U. S. 409, sustained the application of a provision of the Revenue Act of 1921 fixing a new basis for property acquired by gift, in a case in which the property had been acquired in 1916 and had been sold prior to the enactment of the statute. Such retroactive changes in the basis provisions, especially with respect to property transferred pursuant to reorganizations, have

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[30] See the dissenting opinion by Mr. Justice Brandeis in *Untermyer* v. *Anderson*, 276 U. S. 440, 446–449.

been commonplace[31] and have been sustained whenever challenged.[32]

Truly retroactive legislation has recently been considered in *Wilgard Realty Co.* v. *Commissioner*, 127 F. 2d 514 (C. C. A. 2d), certiorari denied, 317 U. S. 655; see also *Commissioner* v. *Corpus Christi T. Co.*, 126 F. 2d 898 (C. C. A. 5th); *D. W. Klein Co.* v. *Commissioner*, 123 F. 2d 871 (C. C. A. 7th), certiorari denied, 315 U. S. 819. These cases involved Section 213 (f) of the Revenue Act of 1939, which was enacted as a legislative reversal of the principles declared in *United States* v. *Hendler*, 303 U. S. 564, and was made effective with respect to each Revenue Act since that of 1924. The *Wilgard* and *Klein* cases applied the Section to transactions occurring in 1932 and the *Corpus Christi* case to one which had occurred in 1931; in all three the taxpayers were unsuccessful.

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[31] See, for example, Section 204 (a) (7) and (8) of the Revenue Act of 1924; Sections 702–706 of the Revenue Act of 1928; Section 113 (a) (7) of the Revenue Act of 1932; Section 113 (a) (5) of the Revenue Act of 1934; Section 113 (a) (7) of the Revenue Act of 1936; Section 115 (h) of the Revenue Act of 1938; Sections 142 and 143 of the Revenue Act of 1942, and Sections 121 and 122 of the Revenue Act of 1943.

[32] *Norman, Saunders & Co.* v. *United States*, 36 F. 2d 1008 (C. Cls.), certiorari denied, 281 U. S. 760; *Osburn California Corp.* v. *Welch*, 39 F. 2d 41 (C. C. A. 9th), certiorari denied, 282 U. S. 850; *Signal Gasoline Corp.* v. *Commissioner*, 25 B. T. A. 861, reversed on other grounds, 66 F. 2d 886 (C. C. A. 9th). See also *Fesler* v. *Commissioner*, 38 F. 2d 155 (C. C. A. 7th), certiorari denied, 281 U. S. 755; *Phipps* v. *Bowers*, 49 F. 2d 996 (C. C. A. 2d); *Jackson* v. *Price*, 74 F. 2d 707 (C. C. A. 2d).

In only three cases has this Court held the retroactive application of any federal tax to be in violation of the Fifth Amendment. *Nichols* v. *Coolidge*, 274 U. S. 531; *Blodgett* v. *Holden*, 275 U. S. 142; *Untermyer* v. *Anderson*, 276 U. S. 440. These cases involved the application of gift and estate taxes to completed transfers made at a time when no such taxes were in existence. They were narrowly restricted by *Milliken* v. *United States*, 283 U. S. 15, which held that a gift made in contemplation of death could be subjected to estate tax at rates higher than those prevailing at the time the gift was made. In *Welch* v. *Henry*, 305 U. S. 134, the Court pointed out, in sustaining a retroactive income tax (p. 148), that these cases are not applicable to income taxes, but in any event the instant case is closer to the *Milliken* case than to the earlier decisions. Section 501 did not impose a new tax; assuming that the Section represents an actual change in the law, its effect here is merely to lessen the tax advantage allowed by Section 112 (b) (7) of the 1938 Act.

A review of the decisions led a commentator to state some ten years ago that[23]—

> "Arbitrary retroactivity" may continue hopefully to rear its head in tax briefs, but for practical purposes, in this field, it is as dead as wager of law

[23] Ballard, Retroactive Federal Taxation, 48 Harv. L. Rev. 592 (1935).

and, except for the decision here under review, the argument has not since been revitalized.

The court below has read *Welch* v. *Henry*, 305 U. S. 134, as standing for the flat rule that an income tax provision cannot be applied retroactively to a year prior to that succeeding the year of the last previous general session of Congress. We do not believe that that decision can be so construed; it does not fix any general limit as to the permissible retroactivity of income tax statutes. The court there sustained a Wisconsin statute enacted in 1935 which imposed a new tax on dividends received in 1933. The Act had been passed by the legislature at its first session after 1933 and that fact was noted in the opinion, but there was no statement or even intimation that an income tax law passed at a subsequent session would on that account be invalid. It should be observed that the Wisconsin statute [34] was retroactive legislation in the strict sense for it imposed a new tax upon income received two years earlier, and even the dissenting opinion in that case seems to agree that there would be no question of the validity (p. 158) of "a remedial measure to confirm or ratify a doubtful administrative interpretation of prior legislation". Cf. *Graham & Foster* v. *Goodcell*, 282 U. S. 409, 426-430.

[34] It may be noted that the restraints imposed by the Fifth Amendment upon Congress are not as broad as those imposed upon the states by the Fourteenth Amendment. *Steward Machine Co.* v. *Davis*, 301 U. S. 548, 584.

Under the most extreme view of the effect of Section 501, it constitutes only a revision of an existing system of taxation and the case is well within even the narrowest limitations which have at any time been applied upon the Congressional power.

CONCLUSION

For the foregoing reasons, the judgment of the Circuit Court of Appeals should be reversed.

Respectfully submitted.

CHARLES FAHY,
Solicitor General.
SAMUEL O. CLARK, Jr.,
Assistant Attorney General.
SEWALL KEY,
J. LOUIS MONARCH,
BERNARD CHERTCOFF,
Special Assistants to the Attorney General.
WALTER J. CUMMINGS, Jr.,
Attorney.

JANUARY 1945.

APPENDIX A

Revenue Act of 1938, c. 289, 52 Stat. 447:

Title I—Income Tax

* * * * * * *

Subtitle C—Supplemental Provisions

* * * * * * *

Supplement B—Computation of Net Income

Sec. 111. Determination of Amount of, and Recognition of, Gain or Loss.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 112.

* * * * * * *

Sec. 112. Recognition of Gain or Loss.

(a) *General Rule.*—Upon the sale or ex-

change of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.—*

* * * * *

(5) *Transfer to Corporation Controlled by Transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

* * * * *

(7) *Election as to Recognition of Gain in Certain Corporate Liquidations.*—

(A) *General Rule.*—In the case of property distributed in complete liquidation of a domestic corporation, if—

(i) the liquidation is made in pursuance of a plan of liquidation adopted after the date of the enactment of this Act, whether the taxable year of the corporation began on, before or after January 1, 1938; and

(ii) the distribution is in complete cancellation or redemption of all the stock, and the transfer of all the property under the liquidation occurs within the month of December, 1938—

then in the case of each qualified electing shareholder (as defined in subparagraph (C)) gain upon the shares owned by him at

the time of the adoption of the plan of liquidation shall be recognized only to the extent provided in subparagraphs (E) and (F).

(B) *Excluded Corporation.*—The term "excluded corporation" means a corporation which at any time between April 9, 1938, and the date of the adoption of the plan of liquidation, both dates inclusive, was the owner of stock possessing 50 per centum or more of the total combined voting power of all classes of stock entitled to vote on the adoption of such plan.

(C) *Qualified Electing Shareholders.*—The term "qualified electing shareholder" means a shareholder (other than an excluded corporation) of any class of stock (whether or not entitled to vote on the adoption of the plan of liquidation) who is a shareholder at the time of the adoption of such plan, and whose written election to have the benefits of subparagraph (A) has been made and filed in accordance with subparagraph (D), but—

(i) in the case of a shareholder other than a corporation, only if written elections have been so filed by shareholders (other than corporations) who at the time of the adoption of the plan of liquidation are owners of stock possessing at least 80 per centum of the total combined voting power (exclusive of voting power possessed by stock owned by corporations) of all classes of stock entitled to vote on the adoption of such plan of liquidation; * * *

* * * * *

(D) *Making and Filing of Elections.*—The written elections referred to in subparagraph (C) must be made and filed in

such manner as to be not in contravention of regulations prescribed by the Commissioner with the approval of the Secretary. The filing must be within thirty days after the adoption of the plan of liquidation, and may be by the liquidating corporation or by the shareholder.

(E) *Noncorporate Shareholders.*—In the case of a qualified electing shareholder other than a corporation—

(i) There shall be recognized, and taxed as a dividend, so much of the gain as is not in excess of his ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, such earnings and profits to be determined as of December 31, 1938, but without diminution by reason of distributions made during the month of December, 1938; and

(ii) There shall be recognized, and taxed as short-term or long-term capital gain, as the case may be, so much of the remainder of the gain as is not in excess of the amount by which the value of that portion of the assets received by him which consists of money, or of stock or securities acquired by the corporation after April 9, 1938, exceeds his ratable share of such earnings and profits.

*   *   *   *   *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

*   *   *   *   *

(8) *Property Acquired by Issuance of Stock or as Paid-in Surplus.*—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112 (b) (5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

* * * * *

(18) *Property Received in Certain Corporate Liquidations.*—If the property was acquired by a shareholder in the liquidation of a corporation in cancellation or redemption of stock with respect to which gain was realized, but with respect to which, as the result of an election made by him under paragraph (7) of section 112 (b), the extent to which gain was recognized was determined under such paragraph, then the basis shall be the same as the basis of such stock cancelled or redeemed in the liquidation, decreased in the amount of any money received by him, and increased in the amount of gain recognized to him.

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

* * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term

"dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

(c) *Distributions in Liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the

extent provided in section 112. Despite the provisions of section 117, the gain so recognized shall be considered as a short-term capital gain, except in the case of amounts distributed in complete liquidation. For the purpose of the preceding sentence, "complete liquidation" includes any one of a series of distributions made by a corporation in complete cancellation or redemption of all of its stock in accordance with a bona fide plan of liquidation and under which the transfer of the property under the liquidation is to be completed within a time specified in the plan, not exceeding, from the close of the taxable year during which is made the first of the series of distributions under the plan, (1) three years, if the first of such series of distributions is made in a taxable year beginning after December 31, 1937, or (2) two years, if the first of such series of distributions was made in a taxable year beginning before January 1, 1938. In the case of amounts distributed (whether before January 1, 1938, or on or after such date) in partial liquidation (other than a distribution to which the provisions of subsection (h) of the section are applicable) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits.

* * * * * *

Second Revenue Act of 1940, c. 757, 54 Stat. 974:

SEC. 501. EARNINGS AND PROFITS OF CORPORATIONS.

(a) *Under Internal Revenue Code.*—Section 115 of the Internal Revenue Code

is amended by inserting at the end thereof the following new subsections:

"(l) *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

"(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

"(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in

determining the increase or decrease above provided.

* * * * * * *

(b) *Effective Date of Amendment.*—The amendment made by subsection (a) shall be applicable to taxable years beginning after December 31, 1938.

(c) *Under Prior Acts.*—For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the date of its enactment. Nothing in this subsection shall affect the tax liability of any taxpayer for any year which, on September 20, 1940, was pending before, or was theretofore determined by, the Board of Tax Appeals, or any court of the United States.

(26 U. S. C. Supp. III, Sec. 115.)

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

ART. 112 (b) (7)-1. *Corporate liquidations in December, 1938.*—(a) *General.*—Section 112 (b) (7) provides a special rule, in the case of certain specifically described complete liquidations of domestic corporations occurring within the month of December, 1938, for the treatment of gain on the shares of stock owned by qualified electing shareholders on the date of the adoption of the plan of liquidation. The effect of such section is in general to postpone the recognition of that portion of a qualified electing shareholder's gain on the liquidation which would otherwise be

recognized and which is attributable to appreciation in the value of certain corporate assets unrealized by the corporation at the time such assets are distributed in complete liquidation. Only qualified electing shareholders are entitled to the benefits of section 112 (b) (7). The determination of who is a qualified electing shareholder is to be made under section 112 (b) (7) (C) and article 112 (b) (7)-2. For the basis of property received on such liquidations see section 113 (a) (18).

(b) *Type of liquidation.*—The liquidation must be in pursuance of a plan of liquidation adopted after May 28, 1938. * * *

If a transaction constitutes a distribution in complete liquidation within the meaning of the Act and satisfies the requirements of section 112 (b) (7), it is immaterial that it is otherwise described under the local law.

ART. 112 (b) (7)-4. *Treatment of gain*—(a) *Computation of gain.*—As in the case of shareholders generally, for the purpose of computing gain, amounts received by qualified electing shareholders are treated as in full payment in exchange for their stock, as provided in section 115 (c), and gain from the receipt of such amounts is determined as provided in section 111. * * *

(b) *Recognition of gain.*—Pursuant to section 112 (b) (7) only so much of the gain on each share of stock owned by a qualified electing shareholder on the date of the adoption of the plan of liquidation is recognized as does not exceed the greater of the following—

(1) Such share's ratable share of the earnings and profits of the corporation ac-

cumulated after February 28, 1913, computed as of ~~December 31, 1938~~, without diminution by reason of distributions made during the month of December, 1938; or

(2) Such share's ratable share of the sum of the amount of money received by such shareholder on shares of the same class and the fair market value of all the stock or securities so received which were acquired by the liquidating corporation after April 9, 1938. * * *

(c) *Treatment of recognized gain.*—In the case of a qualified electing shareholder other than a corporation that part of the recognized gain on a share of stock owned on the date of the adoption of the plan of liquidation which is not in excess of its ratable share of the earnings and profits of the liquidating corporation accumulated after February 28, 1913, determined as provided in section 112 (b) (7) (E) (i) is treated and taxed to him as a dividend. It retains its character as a dividend for all tax purposes. The remainder of the gain which is recognized is treated and taxed to him as a short-term or long-term capital gain, as the case may be. * * *

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ART. 115–2. *Sources of distributions in general.*—For the purpose of income taxation every distribution made by a corporation is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits. * * *

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ART. 115–3. *Earnings or profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or ac-

cumulated prior to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Consitution, as well as all items includible in gross income under section 22 (a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section.[1] Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

* * * * *

ART. 115–5. *Distributions in liquidation.—(a) General.*—Amounts distributed in complete liquidation of a corporation are to be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation are to be treated as in part or full payment in ex-

[1] This sentence appears in the regulations promulgated under preceding Revenue Acts: Article 115–3, Treasury Regulations 94 (1936 Act); Article 115–1, Treasury Regulations 86 (1934 Act). The same sentence appears in the Treasury Regulations promulgated under the Internal Revenue Code: Sec. 19.115–3, Treasury Regulations 103 and Sec. 29.115–3, Treasury Regulations 111. See, also, Sections 19.115–12 and 29.115–12 of the same Regulations.

change for the stock so canceled or redeemed. The gain or loss to a shareholder from a distribution in liquidation is to be determined, as provided in section 111 and article 111-1, by comparing the amount of the distribution with the cost or other basis of the stock provided in section 113; but the gain or loss will be recognized only to the extent provided in section 112.

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APPENDIX B

COMMITTEE REPORTS

THE SECOND REVENUE BILL OF 1940

H. Rep. No. 2894, 76th Cong., 3d Sess., p. 41 (1940-2 Cum. Bull. 496, 526-527):

SECTION 401. EARNINGS AND PROFITS OF CORPORATIONS.

The purpose of this amendment is to clarify the law with respect to what constitutes earnings and profits of a corporation. This is important not only for the purpose of determining whether distributions are taxable dividends but also in determining equity invested capital for excess-profits-tax purposes.

Section 401 of the bill inserts subsection (1) in section 115 of the Internal Revenue Code and correspondingly amends prior Revenue Acts. The rule, applied by the Treasury under existing law, is that while gains or losses which are not recognized by reason of the provisions of section 112 neither increase nor diminish the earnings or profits, the earnings or profits are increased or diminished by the entire amount of the recognized gain or loss, computed in accordance with the provisions of sections 111, 112, and 113. Together with the provisions of section 115 (h) of the Internal Revenue Code, and the principles established in *Commissioner* v. *Sansome* (60 Fed. (2d) 931) and following decisions, the rule effec-

tuates the provisions of section 112. While taxpayers generally have concurred in the rule applied by the Treasury, the Board of Tax Appeals and some of the courts have not agreed but have followed the theory that gain or loss, even though not recognized in computing net income, nevertheless affects earnings and profits. For example, on January 1, 1930, the X corporation owned stock in the Y Corporation which it had acquired in 1929 in a transaction wherein no gain or loss was recognized. The adjusted basis to the X Corporation of the property exchanged by it for the stock in the Y Corporation was $100. The fair market value of the stock in the Y Corporation received by the X Corporation was $1,000. On April 9, 1930, the X Corporation declared a cash dividend of $900 and, except for the possible effect of the transaction in 1929, had no accumulated earnings or profits as of that date. Under the interpretation of the Board and some of the courts, the excess of the fair market value of the stock of the Y Corporation over the basis, $900, would represent earnings or profits, and the cash distribution would be a taxable dividend (*Commissioner* v. *F. J. Young Corporation*, 103 Fed. (2d), 137). Under the proposed legislation and Treasury practice, the $900 would not represent earnings or profits, and the cash distribution would not be a taxable dividend. The need for certainty, not only with respect to the determination of when dividends are taxable but also in the computation of the excess profits tax credit, makes it desirable to clarify existing law.

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It should be noted that the provisions of section 401 are applicable only in determining the earnings or profits for periods beginning after February 28, 1913. * * *

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H. Conference Rep. No. 3002, 76th Cong., 3d Sess., pp. 61–62:

* * * * *

The House bill and Senate amendment provided that, in order to effect a uniform rule for all prior years, the stated rules are made applicable to prior acts, but the Senate amendment added a provision providing that such rules should not affect the tax liability of any taxpayer for any year now pending before, or heretofore determined by, the Board of Tax Appeals, or any court of the United States. The tax liability may be that of the corporation the earnings or profits of which are being determined, or the tax liability of a shareholder of such corporation, or of some other taxpayer. These tax liabilities are left to be determined according to such decisions as the Board or courts may make under existing law. As to all matters except such tax liabilities, such stated rules are applicable, and res judicata will not be applicable. The House recedes with an amendment providing that the exception added by the Senate amendment relative to pending or decided cases shall apply only if the tax liability in question was pending before the Board of Tax Appeals or any court of the United States on September 20, 1940, or was determined prior to such date by the Board of Tax Appeals or any court of the United States.

S. Rep. No. 2114, 76th Cong., 3d Sess., pp. 22, 26 (1940-2 Cum. Bull. 528, 545-548):

SECTION 501. EARNINGS AND PROFITS OF CORPORATIONS.

The committee amendment rearranges section 401 of the House bill but otherwise makes no substantial change. * * *

* * * * *

The subsection also provides that the realized gain or loss shall increase or decrease the earnings and profits (for any period beginning after February 28, 1913) to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. This provision relates to gains or losses which are recognized, pursuant to the provisions of law, for instance, by reason of the provisions of section 112 of the Internal Revenue Code. * * * For example, on January 1, 1939, the X Corporation owned stock in the Y Corporation which it had acquired in 1938 in an exchange transaction in which no gain or loss was recognized. The adjusted basis to the X Corporation of the property exchanged by it for the stock in the Y Corporation was $100. The fair market value of the stock in the Y Corporation when received by the X Corporation was $1,000. On April 9, 1939, the X Corporation declared a cash dividend of $900 and, except for the possible effect of the transaction in 1938, had no accumulated earnings or profits. The excess of the fair market value of the stock of the Y Corporation over the basis, $900, was not recognized gain under the provisions of section 112

of the Revenue Act of 1938. Accordingly, its earnings and profits are not increased by $900 and the distribution was not out of earnings and profits.

The subsection applies regardless of the form taken by the sale or other disposition resulting in the accumulation of earnings and profits. For example, suppose that oil property which X had acquired in 1922 at a cost of $28,000 was transferred to a corporation in 1924 in exchange for all of its capital stock; that the fair market value of the stock and of the property as of the date of the transfer was $247,000; and that the corporation, after three years' operations, effected in 1927 a cash distribution to X in the amount of $165,000. In determining the extent to which the earnings and profits of the corporation available for dividend distributions have been increased as the result of production and sale of oil, it is intended that depletion should be taken into account computed upon the basis of $28,000 established in the nontaxable exchange in 1924 regardless of the fair market value of the property or the stock issued in exchange therefor.

* * * * *

The amendments to the Internal Revenue Code made by section 501 (a) are by section 501 (c) made applicable to all prior Revenue Acts, effective as if they were a part of such Act on the date of its enactment, thus effecting the application of a uniform rule for the determination of the earnings and profits of all corporations for all prior taxable years. The last sentence of the subsection provides that only the actual tax liability of a shareholder-taxpayer for a particular year which is now pending

before, or heretofore determined by, the Board of Tax Appeals or any court of the United States, shall remain unaffected by the provisions of section 501. These cases now actually in litigation are left to be determined as the Board or the court may see fit. The result is that the decision in each of these cases will merely determine the tax liability for the particular year of the particular taxpayer, but for every other purpose the determination of the earnings and profits, and of all matters dependent upon such determination the provision of section 501 govern. Section 501 will therefore control for all purposes as respects the corporation, and as respects the shareholder in litigation for every purpose except that the tax liability for the particular year, as finally determined by the Board or the court, will remain undisturbed.

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U. S. GOVERNMENT PRINTING OFFICE 1941